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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 900

JOHN E. SHERIDAN AND LEO A. CROSSEN, TRUSTEES, MIFFLIN CHEMICAL CORPORATION, DEBTOR IN BANKRUPTCY REORGANIZATION PROCEEDINGS, SECTION 77B, PETITIONER

v.

WALTER J. ROTHENSIES, COLLECTOR OF INTERNAL REVENUE, FIRST COLLECTION DISTRICT OF PENNSYLVANIA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 380–409) is reported in 34 F. Supp. 164. Its opinion on motion for rehearing (R. 421–422) is not reported. The opinion of the Circuit Court of Appeals (R. 425–433) is reported in 123 F. (2d) 311.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on October 29, 1941 (R. 433). The

petition for a writ of certiorari was filed on January 24, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether sales of rubbing alcohol compound by a permittee in excess of its customers' reasonable requirements are subject to tax under Section 4 of the Liquor Law Repeal and Enforcement Act of 1935 and Article 146 of Treasury Regulations 3 as amended by Treasury Decision 4541.

2. Whether the Act and the Regulations construed to impose the tax are valid.

3. Whether in a reorganization proceeding under Section 77–B of the Bankruptcy Act the District Court erred in allowing a claim for taxes without remanding the proceeding to the special master for the taking of additional evidence, where the master had disallowed the claim but had afforded the parties full opportunity to put in their proof.

4. Whether the District Court erred in setting aside findings of fact made by the master.

5. Whether the knowledge of the debtor's sales agents as to the wrongful sales arranged by them was imputable to the debtor, and if not whether the debtor was in any event taxable.

6. Whether the finding of the District Court as to the amount of alcohol wrongfully sold by the debtor is supported by evidence.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set out in the Appendix, *infra,* pp. 14–16.

STATEMENT

The Mifflin Chemical Corporation, referred to as the debtor, was for many years engaged in the business of manufacturing a rubbing alcohol compound under permits to withdraw and use specially denatured alcohol (R. 277–288). On the ground, *inter alia,* that it had sold quantities of its product to certain customers in excess of their reasonable requirements, its permit for 1936 was revoked and its application for a permit for 1937 was denied. *Morgenthau* v. *Mifflin Chemical Corp.,* 93 F. (2d) 82 (C. C. A. 3).

A tax of $254,746.80 was assessed against the debtor at the rate of $2 per gallon on 127,373.40 gallons of alcohol sold during the period August 27, 1935, to December 30, 1935 (R. 276). Thereafter, on January 14, 1938, the debtor filed a petition for reorganization under Section 77–B of the Bankruptcy Act (R. 1). The petition was approved on January 15, 1938, and the matter was referred generally to a special master to make findings of fact and conclusions of law and report thereon to the court (R. 3).

The Collector of Internal Revenue filed proof of claim for the unpaid tax (R. 4–5). Objections to the claim were filed by the debtor (R. 5–7, 323–324). The Collector introduced evidence in support of

the claim (R. 7–269). At the conclusion of this evidence, the debtor moved to dismiss the claim and the Collector moved for the allowance of the claim (R. 271). The master stated that neither motion was necessary since counsel for the debtor had said that he would not offer any testimony and since the case accordingly was to be decided on the evidence then in the record (R. 271). Counsel for the debtor thereupon stated that he had no intention for the present of offering any testimony, but that he would move to strike certain of the testimony introduced to support the claim, and that following the master's action on that motion would advise the master whether or not he would offer any evidence (R. 272). The motion to strike was filed on September 8, 1938 (R. 274, 317–321) and denied by the master on March 27, 1939 (R. 274–275, 321–322). In ruling on the motion the master, after adverting to counsel's reservation of the right to offer testimony, stated that he had concluded that the claim should be disallowed but that he had not finished writing his draft report and that if prior to the filing of his final report counsel should give notice of a desire to introduce evidence he would fix a date for hearing (*id.*). On April 13, 1939, counsel for the debtor notified the master that "we do not intend to produce any testimony" (R. 424).

Thereafter, on April 27, 1939, the master signed and served upon the parties a draft report recom-

mending disallowance of the claim (R. 322–357). The master found that the debtor through two of its salesmen made sales for illegal purposes and that these were not within the reasonable requirements of the purchasers. He concluded, however, that the knowledge of the agents as to the illegal diversion by the customers was not imputable to the debtor and that this circumstance was decisive against the claim for the tax. (R. 352–357.) A supplemental report adopting as final the draft report, supplemented by certain findings of fact requested by the debtor, was prepared by the master (R. 360–363), but he died before signing it. A substituted special master was appointed by the District Court, and on July 11, 1939, he filed a supplemental report approving and incorporating the reports of his predecessor (R. 364–365).

On July 24, 1940, after hearing upon exceptions filed on behalf of the Collector, the District Court rendered its opinion setting aside the report and directing that the tax claim be allowed in the amount of $187,488, together with interest at one-half percent per month from January 15, 1938 (R. 380–409). The debtor filed a motion for rehearing praying that the District Court either disallow the claim or remand the proceeding to the master for the taking of further testimony (R. 409–420). The motion was denied in an opinion (R. 421–422), and on February 10, 1941, the District Court entered its

order setting aside the master's report and allowing the claim in the amount above stated (R. 422).

On April 4, 1941, after the debtor had filed notice of appeal, the District Court entered a decree appointing John E. Sheridan and Leo A. Crossen, petitioners herein, trustees of the debtor corporation (R. 423). Their appointment was confirmed (R. 2) and they prosecuted the appeal to the court below, which affirmed the order of the District Court (R. 433).

ARGUMENT

The decision of the court below affirming that of the District Court is correct and no conflict or other reason for further review is presented. We will answer petitioners' numerous contentions in the order in which they are made.

1. Petitioners contend (Pet. 14–19) that even if the debtor sold its product to customers in excess of their reasonable requirements, as found by the District Court (R. 395–396), such sales were not taxable. This contention was overruled by both lower courts (R. 383, 408, 430). It is based on an untenable construction of the wording and purpose of Section 4 of the Liquor Law Repeal and Enforcement Act of 1935 (49 Stat. 873) and of Article 146 of Treasury Regulations 3, as amended by Treasury Decision 4541, XIV–1 Cum. Bull. 525, 528 (1935).

Section 4 of the Act provides that any person selling denatured alcohol "in violation of laws or regulations now or hereafter in force pertaining

thereto" should be subject to all provisions of law applicable to alcohol not denatured "including those requiring the payment of tax thereon" and should be required to pay the tax, which in this case under Section 2 (4) of the Liquor Taxing Act of 1934 (48 Stat. 313) amounted to $2 per proof gallon (Appendix, *infra*, p. 14). Article 146 of the regulations provides that sales must be confined to certain classes of purchasers and that failure to confine sales to such persons "or the making of sales to such persons in quantities in excess of their reasonable requirements, will constitute bad faith on the part of the permittee and grounds for the revocation of his permit (Appendix, *infra*, p. 15)."

Petitioners argue that this provision, although authorizing revocation of permits on account of sales in excess of reasonable requirements, does not prohibit such sales and that therefore petitioners were guilty of no violation and were not taxable. However, such sales would hardly have been made ground for revocation if it had not been intended to forbid them. The plain purpose of the regulatory and statutory provisions is to protect the revenue by insuring that tax-free alcohol is not diverted and that, if diverted, it will be taxed. It would not effectuate this purpose to read the provisions in the narrow manner urged by petitioners. The provisions are remedial, not penal.[1]

[1] *Various Items* v. *United States*, 282 U. S. 577, 579. Cf. *Helvering* v. *Mitchell*, 303 U. S. 391, 399–405.

And there is nothing in the history of Article 146 to support the claim that because of the difficulty of determining what constitutes "reasonable requirements" in a given instance, sales in excess thereof were not intended to be made taxable. The same difficulty would exist in a proceeding to revoke the seller's permit.

2. Petitioners contend (Pet. 20) that Section 4 of the Liquor Law Repeal and Enforcement Act as applied by the courts below constitutes an unconstitutional delegation of legislative power to the Commissioner, and that Article 146 of the regulations, as applied, is unauthorized. These propositions are unsupported by any authority and are without merit. Section 4 of the Act does not purport to authorize the Commissioner to prescribe a tax. On the contrary the tax was fixed by Congress in Section 2 (4) of the Liquor Taxing Act of 1934 (Appendix, *infra*, p. 14). And Article 146 is clearly valid under the provisions of Section 13 of Title III of the National Prohibition Act (Appendix, *infra*, p. 16) authorizing the Commissioner to issue such regulations governing the distribution, sale, and use of alcohol as may be necessary or proper to secure the revenue and to prevent diversion of alcohol to illegal uses.

3. It is contended (Pet. 21–25) that the District Court erred in allowing the claim without remanding the proceeding to the master in order to afford

petitioners an opportunity to introduce any evidence which they might have to defeat the claim. But, as appears from the statement of facts (*supra*, p. 4), the debtor had ample opportunity to offer evidence in the proceedings before the special master. It simply chose not to do so. The master made it clear that his action disallowing the claim would not be taken upon the debtor's motion for disallowance, but would be a final disposition upon all the evidence which the parties desired to introduce (R. 271, 274–275). Hence the case may not be likened to one in which a dismissal of the suit at the close of the plaintiff's evidence makes it unnecessary for the defendant to put in its testimony. The debtor here could not assume that the disallowance would be sustained and then, after the claim was allowed, delay the proceedings by securing a remand for the purpose of adducing evidence which the master clearly indicated should have been offered, if at all, prior to his report. It may be noted, moreover, that in its motion for rehearing the debtor did not allege what evidence it desired to adduce (R. 419–420), and that in denying the motion the judge was satisfied that no purpose would be served and no pertinent facts would be established by a remand (R. 422).

The decisions relied on by petitioners (Pet. 10, 22–23) were based upon circumstances dissimilar

to those herein and they do not conflict with the decision of the court below.[2]

4. Petitioners contend (Pet. 25–27) that the District Court erred in setting aside the findings of fact made by the master. No particular findings are specified, nor is the sufficiency of the evidence discussed. Moreover, as was pointed out by the District Court (R. 396), the findings of fact made by it were not at variance with those of the master, except in the case of several which dealt with the debtor's knowledge of the diversions of its product and which, insofar as not based on erroneous principles of law, were found to have been unsupported by any evidence (R. 397–407, 408–409). The District Court explicitly stated (R. 397) that the master's findings should be sustained if supported by substantial evidence, and, contrary to petition-

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[2] The referee's disallowance of the claim in *In re John H. Livingston Co.*, 144 Fed. 971 (C. C. A. 2d), was taken upon a motion for disallowance, and, so far as appears from the *per curiam* opinion, there was no occasion for the trustee to introduce any evidence if he desired to do so. The proceeding in *In re Crandall*, 205 Fed. 689 (C. C. A. 9th), was remanded for the reason that the district court erred in treating as conclusive evidence which was not conclusive and which the referee had ignored. The referee in *In re Arthur E. Pratt Co.*, 252 Fed. 917 (N. D. N. Y.), had erred in restricting the introduction of evidence, and in *In re Tenenbaum & Abramowitz*, 56 F. (2d) 217 (S. D. N. Y.), the proceeding was remanded because the referee had failed to consider a presumption in favor of the claimant and the district court had no way of knowing what his findings would have been if the presumption had been taken into account.

ers' assertion (Pet. 26), the same view appears to have been held by the court below (see R. 426, note 4). Thus there is no conflict with the decisions cited by petitioner (Pet. 11, 25) for the same rule.[3]

5. It is contended next (Pet. 27–30) that the courts below erred in overruling the master's conclusion that the debtor was not chargeable with its agents' knowledge of the sales for illegal purposes, which concededly were sales in excess of its customer's reasonable requirements within the meaning of Article 146. The master and perhaps also the District Court considered that scienter was a necessary element of the debtor's taxability (R. 354–357, 396–409). The court below did not decide this question but stated that for purposes of argument it would assume that the debtor was liable for the tax only if knowledge of the diversions was attributable to it (R. 430).

Neither Article 146 nor the pertinent statutes contain any provision that a taxpayer must have knowledge that its sales are wrongful. Certainly it would not be unreasonable to place upon him as a condition of tax exemption the duty of seeing that his sales are proper. Such a duty would seem especially appropriate in circumstances like

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[3] *Kimberly* v. *Arms*, 129 U. S. 512; *In re Pullmatch, Inc.*, 27 F. Supp. 884 (S. D. Ohio); *Wald* v. *Longacre*, 34 F. (2d) 25 (C. C. A. 3d); *Clements* v. *Coppin*, 72 F. (2d) 796 (C. C. A. 9th); *In re Rubins*, 74 F. (2d) 432 (C. C. A. 7th), certiorari denied, 295 U. S. 758.

those here, where the debtor's sales sharply increased during the period in question (R. 388–389, 398). See *Morgenthau* v. *Mifflin Chemical Corp.*, 93 F. (2d) 82, 86, 88 (C. C. A. 3). In any event, the imputation of knowledge here was correct.[4] The two salesmen involved admittedly knew of the illegal diversions and, while in arranging the sales they may have been acting primarily in their own interest, they were not acting beyond the scope of their authority or adversely to their principal.

6. Finally, petitioners contend (Pet. 30–34) that the evidence did not warrant the District Court in making any finding as to the specific amount of alcohol wrongfully sold by the debtor. The District Court found (R. 395) that the debtor's wrongful sales amounted to at least 3,720 gross pint bottles. The evidence supporting this finding is carefully detailed in the court's opinion and the record references are given (R. 384–396). Where the judge found that the proof was not clear, he did not credit it; the original assessment was reduced from $254,746.80 to $187,488. The court below held

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[4] See *Zito* v. *United States*, 64 F. (2d) 772 (C. C. A. 7), and other cases cited in the opinion of the District Court (R. 400–406). See also Restatement of Agency, Secs. 228–231, 282.

The decisions invoked by petitioners (Pet. 11, 27–28) as presenting conflicts with the holding herein were correctly distinguished by the court below (R. 432) on the ground that the agents there involved acted adversely to their principals in the sense either of defrauding them or of acting for the other parties to the transactions.

that there was a substantial basis for the finding as to the amount of the sales, and there is no occasion for further review.

CONCLUSION

The petition for writ of certiorari should be denied for the reasons stated.

Respectfully submitted.

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